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SUBJECT: ARMENIA - MACROECONOMIC OVERVIEW FOR FIRST HALF 2009

REF: A) YEREVAN 151 B) YEREVAN 189

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SUMMARY

1. (SBU) Armenia's GDP declined by 16.3 percent in the first half of 2009, and the decline is expected to exceed 10 percent for the full year, with the construction and mining sectors being hardest hit. Falling remittances and exports, together with rising unemployment, are depressing household incomes and causing poverty to rise. IMF projects modest economic growth in 2010, provided that the expected global recovery materializes. While the GOAM attracted large amounts of donor financing this year to support the state budget and the economy, if the money is not spent efficiently, Armenia will soon end up with huge foreign debt. End Summary.

GDP DECLINES SHARPLY

2. (SBU) Armenia's economy has contracted sharply since the onset of the global economic crisis. In the first half of 2009, GDP declined by 16.3 percent (in the second quarter of 2009 by 22.9 percent) to AMD 1,119 billion (USD 3 billion). The sectors hit hardest and contributing most to this decline include industry and construction -- 11.5 percent and 53.5 percent respectively. According to revised forecasts by the Central Bank (CBA), the annual drop in GDP will be equal to 12-15 percent. Previously the CBA was projecting a 5-6 percent decline. The IMF projects a 10 percent contraction for 2009. Armenia's Ministry of Economy expects the national economy to start recovering in the second half of the year, with possible growth in 2010. As global conditions approve, IMF expects GDP to rise in 2010 by about one percent.

3. (SBU) Industry reported an 11.5 percent year-on-year decline, due primarily to shrinking production volumes in the mining and chemical sectors. The mining sector declined by 9.3 percent, manufacturing by 12.6 percent, and energy by 9.4 percent, due to reduced demand from other industrial sectors. Metallurgy was the only major industrial sector (comprising 18.4 percent of the total manufacturing sector) to grow, showing a 10.1 percent increase, due largely to growth in copper and aluminum foil production. (Note: Copper prices began to recover in February, and GOAM loans helped keep several mining companies in operation during the worst part of the crisis. End Note). Food processing declined 5.7 percent, and the chemical industry contracted by 50.4 percent, due to a decrease in volumes of synthetic rubber production. Manufacturing of non-metallic mineral products declined by 31.8 percent, and jewelry production by 58.7 percent.

4. (SBU) The construction sector, which grew more than five-fold in

real terms since 2001 and began contracting last fall, declined by 52 percent in the first half of 2009, due to decreased capital inflow and incomes. Construction volumes financed by households declined by around 70 percent, whereas construction financed by private companies declined by 20 percent. Construction volumes in June 2009 were double that of May; in an effort to boost the sector, the GOAM provided guarantees to developers -- about USD 54 million -- to help them attract loans from commercial banks and complete unfinished projects.

15. (SBU) The agricultural sector reported a 2.5 percent year-on-year drop in the first half of 2009 due to reduced output both in plant cultivation and livestock sectors. In the livestock sector, milk production declined by about 10 percent and meat production by 4.6 percent. On the other hand, egg production was up by 19.1 percent. Plant cultivation dropped by 1.9 percent. Agriculture, hunting, forestry and fishing contributed -0.2 percentage points to the overall drop of the economy.

16. (SBU) Services reported a slowed growth rate of 1.9 percent, largely because of around a five percent decline in trade. This was due to a 49 percent reduction in car sales, no growth in retail trade turnover, and a five percent decline in wholesale trade. Other services increased by only 0.9 percent, due to a sharp decline in transportation (7.5 percent) and financial services (8.4 percent), and slow growth in communications (4.7 percent).

UNEMPLOYMENT RISES

17. (SBU) According to official statistics, the unemployment rate reached seven percent in June, a 0.7 percentage point increase compared to June 2008. As of June, the number of registered unemployed was 79,100, four thousand more than in January. (Note:

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The official unemployment figure reflects only those who have registered with the state unemployment agency. The Household Survey, which the National Statistical Service carries out annually, showed an actual unemployment rate equal to 23.2 percent in 2008, compared to an official unemployment rate in 2008 of 6.3 percent. The 2009 survey has not yet been released. End Note). The number of unemployed persons who obtained aid from the state totaled 23,700 in June, with the average monthly state unemployment allowance equal to USD 45.

18. (SBU) Despite slow economic activity and growth in labor supply due to a reduced outflow of migrant workers, the average wage increase in June compared to May was 4 percent, explained primarily by wage increases in the public sector. In June, average monthly nominal wages were equal to USD 280. Compared to June 2008, nominal wages increased by 11.6 percent in AMD and decreased by 8.2 percent in USD. The CBA predicts average nominal wages in the economy will decrease by approximately 1.5 percent, due to a reduction of nominal wages in the private sector. The CBA also predicts a 1.6 percentage point increase in the unemployment rate, due to a drop in aggregate demand.

PRIVATE CONSUMPTION DOWN

19. (SBU) According to CBA estimates, in the second quarter of 2009 private expenditures in real terms dropped by around 19 percent, 9-10 percent below its potential level. This was due to reduced incomes from a decline in remittances, uncertainty about the investment climate and negative expectations. During the first six months of the year, private expenditures have created deflationary pressures in the consumer market, reducing inflation by 2.7-3 percentage points.

MONETARY AND EXCHANGE RATE POLICES CONSISTENT

110. (SBU) After depreciating by 22 percent on March 3 following the CBA's decision to stop supporting it (ref A), the Armenian dram (AMD) was stable during the second quarter of 2009. It has held

within a range of AMD 370-380 per USD, with minimal bid/ask spreads suggesting there is little anticipation of another major devaluation. The CBA has intervened only a few times in the forex markets since March 3; mostly, it insists, to smooth excess volatility. The CBA's forex intervention from September 2008 to March 2009 cost over USD 700 million, with the CBA spending up to USD 30 million on some days.

¶11. (SBU) Reduced concerns about the exchange rate have allowed the CBA to ease monetary policy to support economic activity. Since the beginning of April, the CBA has cut its refinancing rate several times -- by a cumulative 1.75 percentage points -- to six percent, after increasing it by one percentage point in March to avoid overshooting of the exchange rate and to maintain confidence in the AMD. Consistent with its primary objective of price stability and in line with low inflation forecasts for the year, the CBA will continue to ease monetary policy in the second half of the year. However, the economic crisis and increased dollarization of the economy have reduced the effectiveness of monetary policy.

INFLATION LOW

¶12. (SBU) Year-on-year inflation was one percent in February and March, increasing to slightly over three percent in April, May and June. This was driven primarily by increases in utility prices in April and the pass-through effects of the AMD devaluation, mostly through higher import prices. Average import prices in June were up by 18.8 percent and export prices down by 14.2 percent compared to June 2008.

¶13. (SBU) Compared to December 2008, foodstuff prices in June were up by 3.2 percent, while prices of non-foodstuffs and services increased by 9 percent and 7.3 percent, respectively, during that same period. In June, prices for gasoline and diesel fuel increased by 8.8 percent and 5.3 percent, respectively, compared to May.

¶14. (SBU) Due to declining domestic demand, the inflation rate is expected to remain low through the end of the year. IMF predicts year-end inflation to be at the lower end of the CBA's target range of 411.5 percent. According to the latest CBA prediction, year-end inflation will be around 3.5 percent.

REMITTANCES DECLINE

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¶15. (SBU) A sharp drop in remittances in the first half of 2009 is one of the major factors behind the double-digit contraction of the Armenian economy. From January to June 2009, net transfers to Armenia through the banking system declined by 36 percent compared to same period in 2008, totaling around USD 600 million. This sharp decline is explained primarily by unfavorable economic conditions in Russia, the main source (about 80 percent) of remittances to Armenia. Remittances had been growing steadily since 2000, before the financial and economic crisis broke out; from January to June 2008, transfers to Armenia increased by 34 percent, comprising approximately 15 percent of Armenia's GDP.

BUDGET REVENUES DOWN

¶16. (SBU) According to preliminary data from the Ministry of Finance, overall budget revenues in January to June 2009 declined by 12.9 percent, compared to the same period in 2008, to AMD 300.4 billion (USD 812 million). This decline is explained mainly by an 18.2 percent decline in collections of taxes and duties, which comprise 77.6 percent of total budget revenues (Note: The remainder comes from social security taxes (15.9 percent), other revenues (5.6 percent) and official grants (less than one percent). End Note).

¶17. (SBU) Budget expenditures for this period amounted to AMD 347.5 billion (USD 939 million), a six percent increase, creating a budget deficit for the first half of 2009 equal to AMD 47 billion (USD 128 million). Budget revenues and expenditures for the first half of

2009 amounted to 33.4 percent and 38.6 percent of the 2009 totals (AMD 905 billion and AMD 945 billion, respectively) projected by the State Budget Program adopted in November, 2008.

¶18. (SBU) VAT collections, the main source of financing for the state budget (44.9 percent of total revenues), were down by 26 percent to AMD 104.8 billion (USD 283 million). Corporate tax proceeds (19.4 percent of total from taxes and duties) fell by 2.7 percent to AMD 45.3 billion (USD 122 million). (Comment: While we would expect VAT revenues to decline due to the global financial crisis, Deputy Finance Minister Vardan Aramyan told us on August 28 that due to the introduction of cash registers in many retail outlets during the past year, official retail turnover for the first seven months of 2009 was double that of the same period in 2008. This increase, however, is not reflected in official statistics. End Comment).

¶19. (SBU) In response to the toughening economic situation and severe shortfall in revenues, in March the GOAM revised its revenue and spending plans for 2009 (Ref B). It reduced projected revenues by 8.1 percent and spending by 9.6 percent. For the first six months of 2009, the budget deficit (project financing from foreign sources not included) was equal to 4.2 percent of GDP. Despite large inflows of donor financing (including from Russia), the Ministry of Finance predicts the annual fiscal deficit to equal 6.5 percent of GDP in 2009, though in a worst-case scenario it may exceed 7.5 percent of GDP. Between 2010-2013, the GOAM projects Armenia's external debt will grow to around 45 percent of GDP (up from 13 percent in 2008).

EXPORTS AND IMPORTS DOWN -----

¶20. (SBU) Armenia's foreign trade turnover declined by 31.5 percent in the first half of 2009, amounting to USD 1.66 billion at current prices. Exports registered a sharp decline of 45.1 percent compared to the same period in 2008, totaling USD 281.3 million. Imports declined by 27.5 percent to USD 1.38 billion. The negative trade balance in January-June totaled USD 1.1 billion, or 34 percent of GDP. (Note: Although the 20 percent devaluation of the AMD on March 3 would have lowered the USD price of Armenian exports, the sector was also affected by falling demand resulting from the global crisis. End Note).

¶21. (SBU) Exports of base metals and mining products, Armenia's main export items, declined by 49.3 percent and 47.8 percent, respectively. Exports of precious and semi-precious stones and metals fell by 47.7, of food products by 48.2 percent.

¶22. (SBU) Armenia's main trading partners remained Russia, Germany, China, Ukraine and the USA. Trade with EU countries (accounting for 30.2 percent of Armenia's total) declined by 46.2 percent. Trade with CIS countries (33.4 percent of total trade) declined by 25.4 percent. Exports to and imports from Russia, Armenia's main trading

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partner, declined by 57.1 percent and 27 percent respectively.

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